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Cirrus Logic, Inc. (CRUS)

Q3 2016 Earnings Call

CORPORATE PARTICIPANTS

Thurman K. Case
*Chief Financial Officer, VP-Finance, Treasurer & Investor Relations
Contact*

Chelsea Heffeman
Director of Investor Relations

Jason P. Rhode
President, Chief Executive Officer & Director

OTHER PARTICIPANTS

Tore Svanberg
Stifel, Nicolaus & Co., Inc.

Christopher J. Longiaru
Sidoti & Co. LLC

Christopher Hemmelgarn
Barclays Capital, Inc.

Thomas Sepenzis
Northland Securities, Inc.

Charlie Lowell Anderson
Dougherty & Co. LLC

MANAGEMENT DISCUSSION SECTION

Thurman K. Case
Chief Financial Officer, VP-Finance, Treasurer & Investor Relations Contact

GAAP AND NON-GAAP FINANCIAL MEASURES

- The Shareholder Letter discussing our financial results, the earnings press release, including a reconciliation of non-GAAP financial information to the most directly comparable GAAP information, along with the webcast of this Q&A session are all available at the company's Investor Relations website at investor.cirrus.com

Jason P. Rhode
President, Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- For a detailed account of our financial results, please read the Shareholder Letter posted on our Investor Relations website
- While short-term weakness for certain portable audio products drove our fiscal Q3 results and our Q4 outlook lower than anticipated, we are on track to deliver 27% y-over-y growth for the full year FY 2016

based on the midpoint of Q4 guidance, and we remain confident in our ability to deliver strong growth in FY 2017

Strategic Initiatives

- Overall, FY 2016 remains an outstanding year as we have expanded share and content with existing customers, ramped 55-nanometer products, and increased our SAM considerably with the introduction of digital headset products
- More importantly, we have executed on numerous strategic initiatives including several new products that we expect to drive strong growth in FY 2017, particularly in H2

Strategy

- Interest in our high performance, ultra-low power audio and voice products has accelerated across a wide range of customers and form factors
- This is being driven in part by features such as always-on voice control and louder sound output, along with a consistent development environment and user experience across a range of price and performance points
- We are confident that our strategy of focusing on innovative market-leading customers in the fastest-growing audio and voice segments will fuel future growth

Market Share

- Specifically, this growth is expected to be driven by increasing content with a number of our existing customers, broadening our market share in handset OEMs 3 through 10 and driving key flagship features into mid-tier mobile devices
- Longer term, the company will leverage the technology developed for mobile into adjacent markets including wearables and the connected home
- Overall we are extremely optimistic about our prospects for sustained revenue growth in the future and our ability to deliver shareholder value

SUMMARY

- Before we begin the Q&A, I would also like to note that while we understand there is intense interest related to our largest customer, in accordance with our policy, we do not discuss specifics about our business relationship

QUESTION AND ANSWER SECTION

Tore Svanberg

Stifel, Nicolaus & Co., Inc.

Q

I was hoping you could talk first a little bit about the – you mentioned in your Shareholder Letter, some reference designs using the Lightning Connector. Is this something that is now already up and running?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Yeah. These are – again, the amount that we can talk about that outside of other folks who are our M5 partners is relatively limited but yeah, there is things that are up and running via the M5 program that people can take and design with today.

Tore Svanberg

Stifel, Nicolaus & Co., Inc.

Q

Okay. And if we sort of translate that to the USB-C opportunity in Android, and specifically for this year, would the opportunity be equal? Or would USB-C maybe come a little bit later?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Well, I don't want to sort of imply anything or do it on the other side of the house, but we do see good opportunities within the current year for USB-C-enabled devices. That's a great connector finally for the Android platform. It's good and durable, small. It's got the nice property that you can figure out – well, you don't have to figure out which direction to plug it in. And it enables people to develop products where you can get low-power data and also power across the connector to the accessory that you're plugging in. So that enables people to develop things like headsets without the need for a battery, which drastically reduces cost and size, et cetera.

So we see really good opportunities within the current year for USB-C. Sometimes, it's difficult to predict these new form factors and whatnot, so there's always – any time a customer is making a foray into new product domains, there's a lot of new people that get votes, and the timing can be uncertain. But we're certainly engaged on a number of different fronts in the Android space with accessories connected to the USB-C port. So we're really excited about the opportunities that opens up for us.

Tore Svanberg

Stifel, Nicolaus & Co., Inc.

Q

Very good. And you talked about a rebalance of share at an Android customer because of – well, they turned to a chipset vendor, I guess. Do we know at this point what percentage that is? And at the same time, you also mentioned you actually expect to expand your share with existing customers. So I'm just wondering if there's something else going on there where maybe you're getting more boosted amplifier content or maybe you could talk a little bit about that, please?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Well, we certainly didn't state or mean to imply that across the board we're increasing content in every socket at every customer. So just overall we think our average content with our customers will go up, but again, that doesn't

– is not intended to imply it goes up across the board in every case. As far as the percentage split, I don't – I've seen all the same speculation. I don't think anybody knows exactly. It's typically done more by carrier so you really never know exactly what the number is until you figure out who orders what. But a reasonably typical split historically would be something more on the 60/40 range in a positive direction for us.

Christopher Hemmelgam

Barclays Capital, Inc.

Q

Hey. How's it going, Jason? So I guess first of all, you're on track for solidly more than 20% growth in FY 2016, which you highlighted, and I think 20% was your target at the start of the year. When you talk about strong growth in FY 2017, would you be targeting something similar to what you've laid out for FY 2016? Or how would you compare the two?

Jason P. Rhode

President, Chief Executive Officer & Director

A

That would involve us having a more precise crystal ball than we've actually got. But just taking all things into account, the expected content expansion we've got in the areas that we expect, if you look at our model in general, we think one of the things, one of the characteristics of a successful company and one of the things we pay our people on in a lot of cases is tied to 15% revenue growth. So if we're excited about revenue growth and we expect it to be strong, then you can certainly imagine our expectations are higher than that. But again, there's all sorts of moving parts that we don't get to control.

Christopher Hemmelgam

Barclays Capital, Inc.

Q

Very helpful.

Jason P. Rhode

President, Chief Executive Officer & Director

A

Nonetheless, the things that are under our control, we're really excited about. We've done a great job of moving onto the 55-nanometer platform so we really don't have any major retrenching to do in terms of the technology that we're providing. We're in a pretty rich period of new product introductions from the company, which is certainly good from a revenue as well as margin perspective. And then there's just a lot of exciting things going on in audio and voice. So we think the net of all that positions us extremely well for FY 2017.

Christopher Hemmelgam

Barclays Capital, Inc.

Q

Thank you. Just as a quick follow-up, digging further into that March and the Android commentary you've made. You did talk about dual sourcing. As Tore mentioned, there's a new product ramping. Net-net, do you expect your Android revenue to be up or down in the March quarter vs. December?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Let's see. Yeah, we don't break it out that way, so it's probably not best for me to break it out relative to the current quarter. But taking everything into account, and that included is what feeds into the guidance that we've issued. Yeah, so that's kind of about the most complete answer I can give you for that.

Charlie Lowell Anderson

Dougherty & Co. LLC

Q

Jason, it sounds like from the shareholder letter that your visibility has definitely improved on the noise-cancelling headphones front, and I wondered – you talk about meaningful revenue in the CY. I wonder if you can talk to timing on that, what quarter we start to see that ramp. And then also we get questions all the time on mix of is it in the box, is it out of the box? Just at a broad level, how is that looking based on the conversations you're having with customers?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Well, let's see. So there's a range of things that I guess I want to try to feed into that question. Number one, as we tried to highlight in the Shareholder Letter, we do have a range of products that are applicable for headsets, both for USB or otherwise. So that's one thing to bear in mind. I'm excited, and I think everybody we've shown the noise-cancelling headset solution to is excited about the possibilities. There are definitely people considering putting that in box, but as I said in response to one of the earlier questions, any time you're considering a new form factor, there's lots and lots of people that get involved at pretty much any customer, and things move around a fair amount.

And then two, coupling that with anytime somebody talks about adding content inside a box, inside the box it ships with a phone, you end up – you can imagine the agonizing that goes into any additional micro penny that gets added to the box. So lots of discussions about that. Nonetheless I do feel confident in the Android space that we will get customers shipping meaningful volumes of noise cancelling headsets sometime in the not too distant future. And then of course I don't really have any comment on the – well, outside of the Android space.

Charlie Lowell Anderson

Dougherty & Co. LLC

Q

Great, and then on microphones. I know that's a key area of focus for you, adding capacity there. I wonder if you could update on that, and maybe sort of timing when you feel like you'll have more capacity to serve that market in a little bit bigger way?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Yeah, thanks for that. We're really excited about where we're headed with microphones. We've got a great team, having put the team in Austin as well as the U.K. team, formerly the Wolfson. Together, they're making great progress, getting yields ironed out, and really figuring out with our customers what we need to do to be a real primetime player in the microphone space. So we're shipping into flagship phones today, not necessarily the highest volume models, but certainly designs that we won based on the size and performance of the microphones we provide. We're earning our stripes in that business, adding capacity as you referred to.

And really more even than the capacity, which is a relatively tractable thing to do, the bigger piece of it is just pretty much any microphone supplier that I've heard tales of from our customer has dealt them a surprise at one time or another. Pretty much across the board, anybody making handsets. Microphones are tricky, and they're difficult things to manufacture really reliably in production. So we've got a great reputation for execution, for reliability and quality. We want to maintain that and not compromise it by biting off more than we can chew in the microphone space. So that's certainly a work in progress.

I think the team is making excellent progress to date and is expected to continue to do that this year. There's a lot of opportunities for microphones, both in handsets going forward as manufacturers are talking about four and five microphones per handset, but also in noise-canceling headsets, as you alluded to. It's an additional very large potential opportunity, in particular, for very small form factor microphones which happens to be one of the things we're good at.

So the nut of it all is I don't have a real detailed update of exactly when, and what and how much other than we're making very good progress. We've got good relationships. We're getting a look at different opportunities at various different customers and trying to put ourselves in a position to be able to commit to that, capitalize on it, and at the same time, uphold our stellar reputation for quality and reliability, which I think will be something that causes us to stand out in the microphone space.

Christopher J. Longiaru

Sidoti & Co. LLC

Q

I'm going to put you back on the MEMS mic part of it because you're talking about a ramp with the noise cancellation headset technology in H2 which requires both your codec but also a couple of MEMS mics as well. How, is there any difference if somebody uses competitor MEMS mic in your codec and your software? Or is your MEMS mic something that makes it easier to implement? And if so, is the capacity something you have to get to before that H2 ramp?

Jason P. Rhode

President, Chief Executive Officer & Director

A

So we do think, we've got a couple of mics in particular that are really well-suited to headsets just due to the size. In particular, if a customer was going to try to do what we refer to in the Shareholder Letter as a non-sealed ear bud, which is what I think is the most compelling form factor, that really puts some size constraints on the microphones. We have mics that are well-suited to that application. I think we probably could support a few folks with the volume that we've got in place today. And that's something we'd entertain. But certainly, you could use a wide range of microphones in that socket and achieve a perfectly functional system. Obviously, we think there's some advantages to using our mics or we wouldn't be pursuing that space.

But, and then in the longer term, we do think we've got a couple tricks up our sleeve that we've talked about in the past in terms of designing the microphones and the smart codec and in this case in particular, the ANC smart codec. Designing those two components together as a system. In the long run, we think we can deliver value for our customers in terms of performance and power, size, et cetera, that would be difficult for somebody to match, just designing the microphones on their own. But the game plan for this year is really from an interface and from a function that the microphone itself is providing, that could be fulfilled by a variety of different mics. So we don't see that as a limitation this year.

Christopher J. Longiaru

Sidoti & Co. LLC

Q

Okay. Great. And then the other question I just have is you guys had alluded to some long-term plans for operating expenses. And you had talked about 15% growth. But I just want to know if your operating expense outlook has changed at all since the last conference call. And if so, what should we be modeling?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Well, certainly our first and foremost our goal is really more around on an annual basis, delivering something in the 20% range for operating profit. Obviously that's a goal that isn't a one quarter goal. It's more of an annual goal because our business is fairly cyclical. Within that context, we expect to grow pretty meaningfully. Like I said, we already are on track to grow 27% in FY 2016. We expect to grow further in FY 2017.

So we're investing for the future. We want to make sure that we appropriately scale R&D to be able to keep up with that growth and deliver growth off a new higher base. And at the same time, we're trying to keep a close eye on SG&A because we should have some leverage there. And you can see that reflected in our outlook for expense in the current quarter. It's a little more flat, frankly, relative to the December quarter than it might normally be. Typically in the January quarter you've got a number of factors popping online, various withholding and whatnot that can drive expense up in the quarter as well.

We've got, I would say, a slightly, a somewhat higher than normal number of Rev A tape-outs in the current quarter. So taking all that into account, the fact that the expense guidance for the current quarter is not up much is an indication that we're certainly keeping an eye on things. But over the course of the year, we would expect to meaningfully add to the R&D number.

Thomas Sepenzis

Northland Securities, Inc.

Q

First one is just in terms of – you say in your letter that you expect strong growth for the year. Any chance that you want to take a stab at what that means? Is that above 10% growth, or, can you characterize it?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Well, I think we addressed that a little bit earlier, but our model and what we pay people on is based around a 15% growth. So if we were talking about 10%, we wouldn't be calling that strong or be very excited about it. Like I said earlier, our crystal ball is not so good that I want to put a specific number on the out-quarters of the year, obviously.

Two, one of the plusses – sometimes a plus and sometimes a minus – mostly a plus – in our business is that we don't do second source products. We've either won or lost designs a year before they actually show up as revenue. So we feel good about the design wins and the customers we're engaged in today, but ultimately it depends on the customers shipping their products successfully in the long run, and if I had the ability to call that a year in advance, I could probably find more lucrative things to do than this.

So we'll decline to put a number on it, but overall we feel really good about what we're lining up for the year. We see growth coming in a number of different avenues as kind of outlined in the release in the letter through expanding our business with a number of our existing customers, continuing to make good progress, broadening our business out into three through ten, and then driving some of these features down from the flagship into mid-tier, which is something we've made good progress on. And then as well, of course the whole wide variety of headset initiatives that we're engaged in. So a number of things adding up to cause us to be pretty bullish going into the new year.

Thomas Sepenzis

Northland Securities, Inc.

Q

Great. And then in terms of the new Android customer, is that an entirely new fourth customer? Or is that more product going into the new third customer?

Jason P. Rhode

President, Chief Executive Officer & Director

A

Well, I guess in that particular case, it depends on how you look at it. I suppose since we had a VP on stage during their introduction, I can say we did start shipping into the Lenovo side of the business at that third or fourth customer, depending on how you want to count. We do see good opportunities outside of them in China as well, and I feel like we're making pretty good progress on that front.

Tore Svanberg

Stifel, Nicolaus & Co., Inc.

Q

Yeah, I just had some follow up questions for Thurman. So first of all – and by the way, I'm very impressed with the inventories given how volatile the smartphone market really is, so congrats on that. But more specifically, if we look at inventories going forward, as you start to ramp up for – and you mentioned a strong ramp H2 the year. When would we expect to see the inventory build for that? Would it be already in March? Or more the June quarter?

Thurman K. Case

Chief Financial Officer, VP-Finance, Treasurer & Investor Relations Contact

A

We would expect the March quarter to be down this year. But when we hit the June quarter you'll see us start to build inventory as we head into the ramps and the busier seasons.

Tore Svanberg

Stifel, Nicolaus & Co., Inc.

Q

Okay, very good. And the other question was on taxes. So I know that you're moving more to an offshore structure in FY 2017, but I also know there's some potential U.S. R&D credits out there that are now permanent. So is that something that already is included in your tax guidance for the year or not?

Thurman K. Case

Chief Financial Officer, VP-Finance, Treasurer & Investor Relations Contact

A

Yes, when we talked about the expected effective tax rate of being 28% to 30% next year, it does include those tax credits.

Chelsea Heffernan

Director of Investor Relations

We had one that was not asked. Do you intend to repurchase shares this quarter?

Jason P. Rhode

President, Chief Executive Officer & Director

Q3 HIGHLIGHTS

Shareholder Letter

- So our general approach to buybacks is we will tee them up and then not make a whole lot of noise about them
- We report our progress on the buybacks each quarter when we release our Shareholder Letter

- So I refer you to the Shareholder Letter for details of the amount of authorization remaining and what we've done to date
 - But as far as what we may be able to take off in the coming quarter, we'll update you on that on the next earnings call

Share Count

- Generally speaking, though, I'll note that we tee up buybacks with the expectation that we execute on them over the long run
- We try not to make a whole lot of noise about that, generally speaking
- It's in everybody's interest or at least our long-term shareholders' interest for us to get as many shares off as possible and so that's kind of why we view it a little more opportunistically and we tend not to make a whole lot of noise about it
- We've got a pretty good track record of having reduced the share count by a pretty significant amount over the years
 - So anyway, anything further than that I'll defer and update you on the next earnings call

Jason P. Rhode

President, Chief Executive Officer & Director

CLOSING REMARKS

- In summary we remain highly-focused on delivering a broad platform of innovative audio and voice components that target the rapidly-growing mobile phone, smart accessory and digital headset markets
- With a compelling portfolio of sophisticated products including hardware, software and algorithms, and a solid customer base comprised of many industry leaders, we are extremely optimistic about our outlook for FY 2017 and beyond.

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